Yen 4Sight

Highlights

- The BoJ left policy unchanged. But while it revised slightly higher its growth forecasts, risks have become more skewed to the downside following the outbreak of China's coronavirus.
- Despite a modest recovery in December IP fell sharply in Q4, as did exports. But weaker imports should support growth.
- The coming week will bring final January PMIs, as well as December consumption and labour earnings figures.

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Interest and exchange rate forecasts

End period	31-Jan	Q120	Q220	Q320
BoJ ONR %	-0.10	-0.10	-0.10	-0.10
10Y JGB %	-0.07	-0.10	-0.10	-0.10
JPY/USD	109	108	106	105
JPY/EUR	120	120	118	117

Source: Bloomberg, BoJ and Daiwa Capital Markets Europe Ltd.

BoJ keeps policy and outlook little changed

There were no surprises from the BoJ's first Policy Board meeting of 2020, with the main yield curve control parameters – -0.1% policy rate and 0% 10Y JGB target – left unchanged. While mindful of the side effects, Governor Kuroda insisted that the benefits of the BoJ's negative rates continue to outweigh the costs, and suggested no imminent desire to review the policy framework. And the BoJ's Outlook Report arguably suggested no need to amend the current policy stance, with no meaningful revisions made to the Board's assessment of the outlook. Admittedly, the BoJ revised up its growth projections across the forecast horizon, in part reflecting the government's fiscal stimulus package. But while the BoJ maintained its view that the economy is likely to continue on an expanding trend, and at a rate slightly above potential, it also nudged slightly lower its expectation for core inflation over the forecast horizon. But core inflation is still expected to continue to fall short of the 2% target.

But risks skewed to the downside

While the BoJ echoed recent assertions of other major central banks that concerns about global demand had recently decreased somewhat, Kuroda emphasised that the associated risks remained significant and firmly skewed to the downside. The BoJ also unsurprisingly flagged recent weakness in domestic demand related to October's consumption tax hike and natural disasters. But while the latest data suggest that the impact of these events started to wane towards the end of last year, the outbreak of China's coronavirus poses a new downside risk. It is, of course, too soon to be able to assess the likely severity, duration and extent of the transmission of the virus. And so the eventual economic costs will also be unclear for some time yet. But given the anticipated substantive hit to Chinese GDP growth in Q1 (at least), Japan's economy will not be unscathed.

Japanese economy not immune to coronavirus

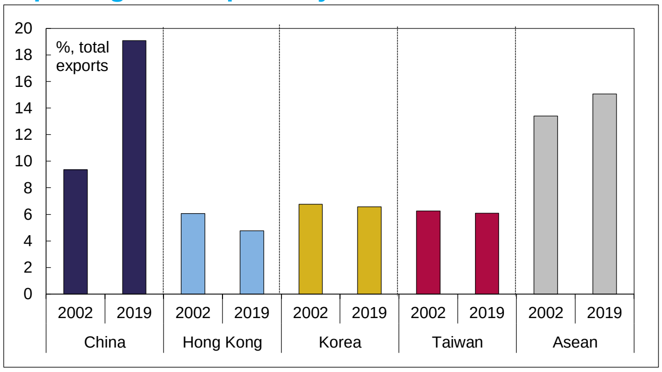
Admittedly Japan's economy was relatively immune to the SARS infection in 2002/3. Studies suggest that Japanese GDP growth was probably reduced by just 0.1ppt in 2003, compared to a hit of about 1ppt to Chinese growth, and more still for Hong Kong. But Japan's economic openness and the importance of China as a trading partner have increased significantly since then. Indeed, Japanese goods exports to China now account for almost 20% of the total, more than twice the share at the time of SARS. And they are now worth more than 2½% of GDP. In addition, shipments to elsewhere in Asia account for more

BoJ: Growth and inflation forecasts*

	Real GDP		Core CPI		*Core CPI excl. policies*	
	Outlook Report Jan-20		Outlook Report Jan-20		Outlook Report Jan-20	
FY19	0.8 (0.6)	↑	0.6 (0.7)	↓	*0.4 (0.5)*	↓
FY20	0.9 (0.7)	↑	1.0 (1.1)	↓	*0.9 (1.0)*	↓
FY21	1.1 (1.0)	↑	1.4 (1.5)			↓

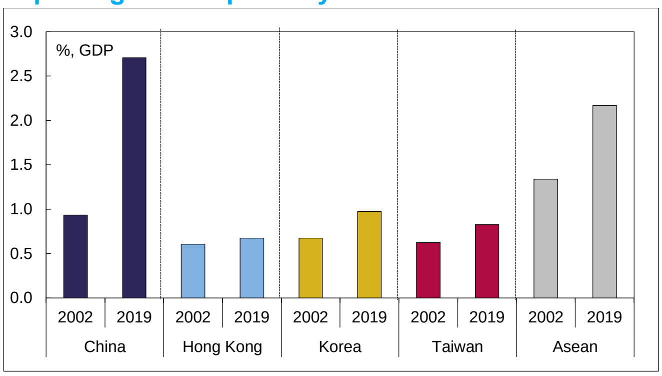
**Policy Board members' median forecast in January's Outlook Report. Figures in parentheses represent October 2019 forecasts. Arrows indicate direction of adjustment. Source: BoJ*

Japan's goods exports by destination



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Japan's goods exports by destination



Source: Thomson Reuters and Daiwa Capital Markets Europe Ltd.

than 4½% of GDP. And the increasing importance of tourism in Japan's economy means that services exports face a greater hit this time around. China and Hong Kong together account for almost one third of spending by overseas visitors to Japan. So, the longer the travel ban in China persists, the greater the hit to hospitality, tourism and other services in Japan. The ultimate impact on net trade is unclear, with Japan's dependence on imports from Asia (almost half of the total) having also risen over the past decade. And the large share of intermediate goods imports coming from the region also raises concerns about possible supply-chain disruption for manufacturers.

Net exports provided a modest boost in Q4

Before the virus gained prominence there had been some hints at a pickup in demand from China. Indeed, Japanese exports to that country rose in December for the second successive month, to leave them up almost 4%Q/Q and more than 6%Y/Y in Q4. This in part reflected improved shipments from the tech sector, tallying with evidence from other countries of a turn for the better in the global semiconductor cycle. It also reflected front-loading of demand ahead of an earlier Lunar New Year in 2020. Less positively, weakness in demand for autos contributed to another notable drop in shipments to the US, with the near-8%Q/Q drop in Q4 the steepest since mid-2011. And overall, while export volumes rose 1.8%M/M in December, the most in six months, this still left them down more than 2%Q/Q in Q4, more than reversing the increase in Q3. Nevertheless, despite a pickup in December, import volumes tracked weaker domestic demand to be down almost 3%Q/Q in Q4, suggesting that net trade should have provided some cushion to GDP growth last quarter.

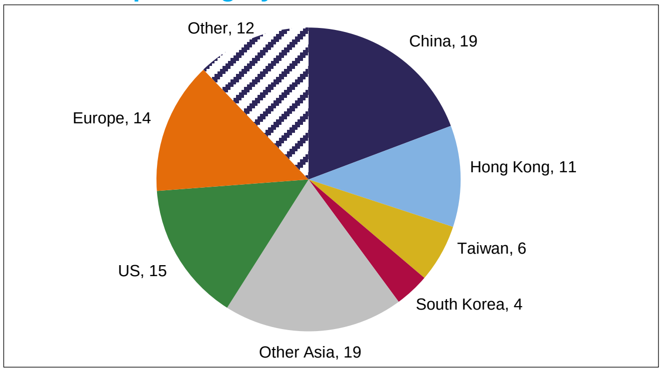
Manufacturing a sizeable drag on growth in Q4

Consistent with gradually improving domestic and external demand, there was a welcome pickup in industrial production in December (1.3%M/M), marking the first monthly increase since September. This was led by the production machinery sector, with the near-16%M/M increase the strongest since the series began in 2003. There were solid increases in general and electrical machinery output too. But autos production continued to disappoint, with the ½%M/M decline reversing the increase seen in November to leave such output down almost 10%Q/Q in Q4. And overall, manufacturing output declined 4%Q/Q in Q4, the steepest quarterly drop since the aftermath of the Great East Japan Earthquake in 2011.

Manufacturing outlook remains underwhelming

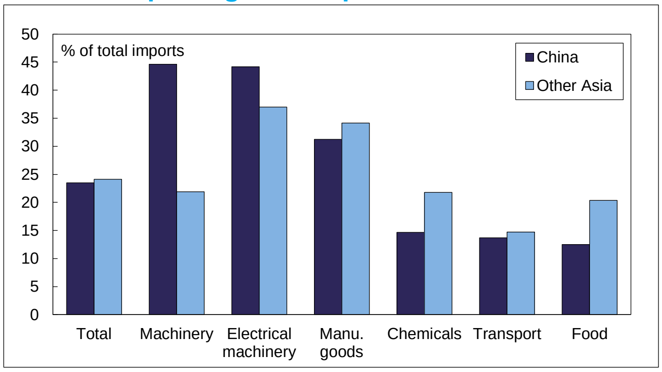
While the flash manufacturing PMI for January – up 2.1pts to 49.3, a twelve-month high – signalled a further improvement in conditions in the sector at the start of the year, this survey won't yet reflect heightened concerns surrounding the coronavirus. Moreover, other detail of the IP report was less encouraging. Indeed, inventories in December rose to their highest level since the height of the Global Financial Crisis. This left the inventory-shipment ratio surging to its second-highest level since the series began in the late 1970s with an increase of 27%Y/Y consistent with further significant declines in the annual rate of production growth over coming months. Certainly, the knock-on effect from the anticipated hit to China's growth in Q1 (at least) and potentially elsewhere in Asia, suggests an underwhelming outlook for Japan's manufacturing sector.

Share of spending by overseas visitors*



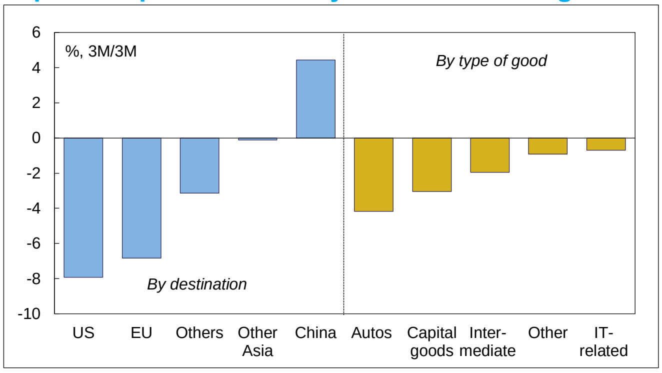
Q419. Source: JTA and Daiwa Capital Markets Europe Ltd.

Share of Japan's goods imports from Asia*



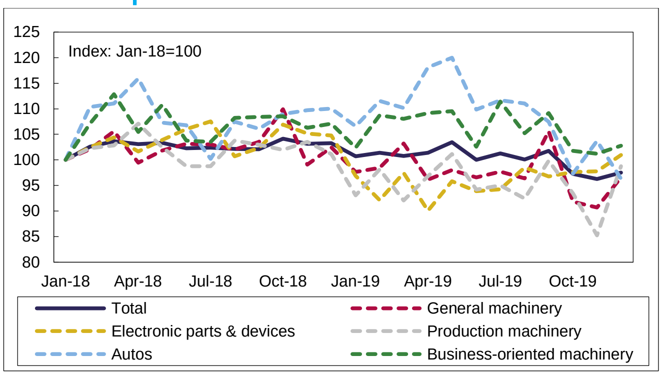
2019. Source: MoF and Daiwa Capital Markets Europe Ltd.

Japan's export volumes by destination and good*



Q419. Source: BoJ and Daiwa Capital Markets Europe Ltd.

Industrial production



Source: METI and Daiwa Capital Markets Europe Ltd.

Recovery in retailing remains underwhelming

Restrictions on travel to and from China will have consequences for Japan's services sector, including retail. That comes after a disappointing end to last year for sales. Certainly, the 0.2%M/M increase in retail sales in December fell short of expectations. The weakness in part reflected clothing sales, which were hit by unseasonably warm weather. The drop left sales down more than 2½%Y/Y and a sizeable 6.1%Q/Q in Q4, only slightly smaller than the equivalent decline in the quarter following the 2014 tax increase. Thankfully, retail sales rarely provide a reliable guide to the national accounts measure of consumption.

Employment rises to new record high

The latest labour market figures were more encouraging, with employment up for the sixth month out of the past seven in December. This left the total number of people employed at a new record high (67.82mn), an increase of 850k over the past year, with solid growth in finance, retail, and information and communications. As such, the unemployment rate moved sideways at 2.2%, the joint-lowest since 1992 to suggest the tightest labour market of the major economies. The job-to-applicant ratio (unchanged at 1.57x) similarly continued to signal supply constraints in the labour market, albeit to a lesser extent than over recent years. And while new job offers have trended lower over the past six months, they remained relatively high, suggesting that employment growth should (in the absence of a big adverse shock from the coronavirus) maintain an upward trend.

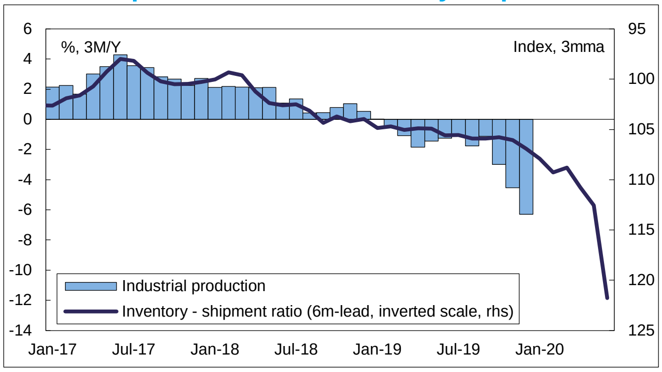
Price pressures remain weak

Despite diminished spare capacity in the labour market, price pressures in Japan remain limited. January's Tokyo CPI figures saw headline inflation fall 0.4ppt to 0.6%Y/Y (0.3%Y/Y when excluding the impact of the consumption tax hike and government education policies). The drop principally reflected weaker fresh food inflation, down 6.4ppts to 1.1%Y/Y. So, the BoJ's forecast measure of core CPI in Tokyo fell just 0.1ppt to 0.7%Y/Y. Despite higher gasoline prices, weaker electricity and gas charges weighed on energy inflation. Excluding fresh foods and energy, the BoJ's preferred Tokyo core measure moved sideways at 0.9%Y/Y, still suggesting subdued underlying price pressures. As for growth, risks to the inflation outlook look skewed to the downside. Lower oil prices and soft demand will weigh on prices. And free higher education from April will push headline CPI lower. So, while the BoJ last week nudged down its inflation forecast, it still looks overoptimistic. But the hurdle for further easing is high and we expect the BoJ's main policy parameters to remain unchanged for the foreseeable future.

Looking ahead…

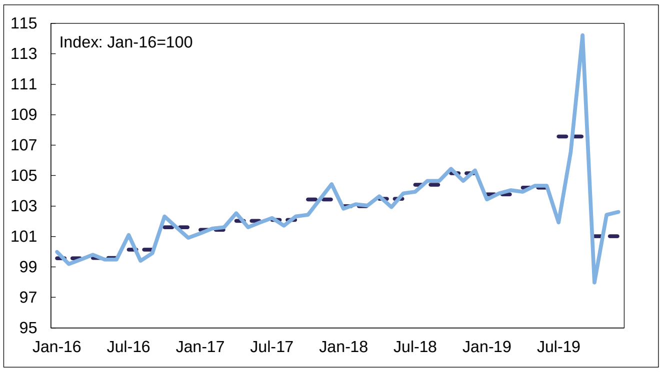
The first half of the coming week will bring the final manufacturing and services PMIs (Monday and Wednesday respectively). While these might bring downwards revisions from the upbeat flash estimates, they seem unlikely to reflect intensified concerns surrounding the coronavirus. The back end of the week will bring an update on household expenditure at the end of last year, with the BoJ's consumption activity index and household spending figures for December due on Friday. That day will also bring the latest labour earning figures, as well as the Cabinet Office's composite business indicators for December.

Industrial production and inventory-shipment ratio



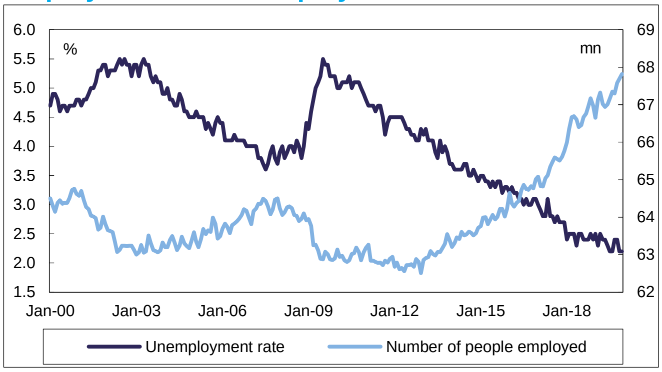
Source: METI and Daiwa Capital Markets Europe Ltd.

Retail sales*



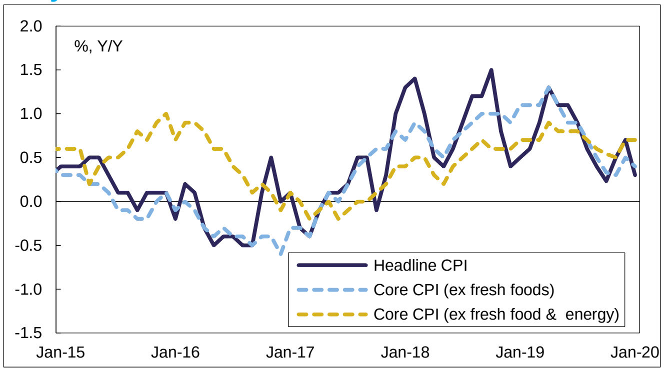
**Dashed dark blue lines represent quarterly averages.*
Source: METI, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Employment and unemployment rate



Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.

Tokyo CPI: Headline and core inflation*



**Excluding the impact of the consumption tax hike and government education policies. Source: MIC, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

Economic calendar

Key data releases – January/February

27	28	29	30	31
	40Y JGB AUCTION SERVICES PPI Y/Y% NOV 2.1 DEC 2.1	CONSUMER CONFIDENCE DEC 39.1 JAN 39.1 SUMMARY OF OPINIONS AT THE BOJ POLICY BOARD MEETING (20-21 JANUARY 2020)	2Y JGB AUCTION	3M TB AUCTION TOKYO CPI Y/Y% DEC JAN 1.0 0.6 *EX FRESH FOOD* *0.8 0.7* *EX FRESH FOOD/ENERGY* *0.9 0.9* RETAIL SALES M/M% NOV 4.5 DEC 0.2 INDUSTRIAL PRODUCTION M/M% NOV -1.0 DEC P 1.3 UNEMPLOYMENT RATE % NOV 2.2 DEC 2.2 JOB-TO-APPLICANT RATIO NOV 1.57 DEC 1.57 HOUSING STARTS Y/Y% NOV -12.7 DEC -7.9 CONSTRUCTION ORDERS Y/Y% NOV -1.2 DEC 21.4
03	**04**	**05**	**06**	**07**
MANUFACTURING PMI DEC 48.4 JAN F 49.3 VEHICLE SALES Y/Y% DEC -9.5 JAN N/A	10Y JGB AUCTION (APPROX ¥2.1TRN) MONETARY BASE Y/Y% DEC 3.2 JAN N/A	SERVICES PMI DEC 49.4 JAN F 52.1 COMPOSITE PMI DEC 48.6 JAN F 51.1	6M TB AUCTION (APPROX ¥2.6TRN) 30Y JGB AUCTION (APPROX ¥0.7TRN)	3M TB AUCTION (APPROX ¥4.4TRN) HOUSEHOLD SPENDING Y/Y% NOV -2.0 DEC -1.6 AVERAGE WAGES Y/Y% NOV 0.1 DEC 0.1 BOJ CONSUMPTION ACTIVITY INDEX M/M% NOV 2.8 DEC N/A COINCIDENT INDEX NOV 94.7 DEC P 94.7 LEADING INDEX NOV 90.8 DEC P 91.3
10	**11**	**12**	**13**	**14**
ECONOMY WATCHERS SURVEY (JAN) BANK LENDING (JAN) CURRENT ACCOUNT (DEC)		10Y JGBI AUCTION M3 MONEY SUPPLY (JAN)	GOODS PPI (JAN)	3M TB AUCTION AUCTION FOR ENHANCED LIQUIDITY TERTIARY ACTIVITY (DEC)
17	**18**	**19**	**20**	**21**
GDP (Q4 P) REUTERS TANKAN (FEB) INDUSTRIAL PRODUCTION (DEC F)	5Y JGB AUCTION	1Y TB AUCTION GOODS TRADE BALANCE (JAN) MACHINE ORDERS (DEC) OVERSEAS VISITORS (JAN) DEPARTMENT STORE SALES* (JAN)	20Y JGB AUCTION	3M TB AUCTION NATIONAL CPI (JAN)

**Approximate date of release. Source: BoJ, MoF, Bloomberg, Thomson Reuters and Daiwa Capital Markets Europe Ltd.*

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